INVESTMENT ADVISER
ASSOCIATION

April 20, 2010

Via Electronic Mail

The Honorable Paul Fong, Chair
Committee on Elections and Redistricting
California State Assembly
State Capitol
10th and L Street
Sacramento, CA 95814

Re: Comments on California A.B. No. 1743: Regulation of "Placement Agents"

Dear Assembly Member Fong:

The Investment Adviser Association ("IAA") appreciates the opportunity to submit comments on California Assembly Bill No. 1743 ("AB 1743"), which would define "placement agents" as lobbyists under the California Political Reform Act of 1974 ("PRA"). The IAA is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the IAA's membership consists of more than 470 firms that collectively manage in excess of $9 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, endowments, foundations, and corporations. Some of our members may be retained as investment managers to manage assets of California public retirement systems under an investment management contract.

We commend efforts to promote disclosure and transparency in the investment process for California public retirement systems. We support measures to address the types of abuses recently discovered in awarding investments of system assets to certain private funds paying "sham fees" to "finders" for providing connections to system officials. We comment with regard only to a narrow aspect of AB 1743 that may negatively affect SEC-registered investment advisers that are selected to manage a portion of California public retirement system assets on the basis of a competitive bidding process, such as a request for proposal ("RFP") or state procurement process, and request an amendment to the definition of "placement agent."

The definition of "placement agent" in AB 1743 includes internal sales personnel employed by investment advisers, thus subjecting them to the contingent compensation ban

applicable to lobbyists.[1] Internal sales and marketing personnel are typically compensated based at least in part on the success of their efforts in attracting new business to the advisory firm. These compensation practices are an appropriate means of linking pay to performance for advisory employees, and the use of these practices is well-known to clients whose business is being solicited by such employees. As discussed below, these employment and business practices are also known and regulated by the SEC, which requires advisers to disclose the nature of the affiliation of sales employees to potential clients.

We understand the serious concerns related to compensating an unregistered "finder" who may perform little or no services for an investment adviser to solicit a California public retirement system. However, we do not believe these same concerns are present where an in-house sales employee of an SEC-registered investment adviser is compensated for soliciting a California public retirement system that selects an SEC-registered investment adviser after a competitive bidding process. The competitive bidding process protects retirement system assets from potential abuse in the award of investment management contracts. RFPs issued in such processes typically include disclosure requirements related to compensation practices for an investment adviser's portfolio managers as well as in-house sales personnel. Under the Investment Advisers Act of 1940, as amended ("Advisers Act"), SEC-registered investment advisers must also provide to prospective clients a written disclosure statement setting forth a wide range of information concerning a firm's business, including information relating to any arrangements where it directly or indirectly compensates any person for client referrals.

In addition to making required disclosures, SEC-registered investment advisers are fiduciaries under the Advisers Act. As fiduciaries, investment advisers and their employees must place their clients' interests above their own. As a result, investment advisers and their employees must conduct any solicitation activities in accordance with their broad fiduciary obligations to clients and the specific requirements of the Advisers Act. In particular, Advisers Act cash solicitation rule 206(4)-3 permits investment advisers to pay cash referral fees to a "solicitor" only if the solicitation activity meets certain requirements.[2] The rule

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[1] AB 1743 would amend the definition of "lobbyist" under the PRA to include "placement agents," who would be subject to lobbyist registration, ethics, and reporting requirements under the Act, including a prohibition on accepting any payment contingent upon any "administrative action." AB 1743 would amend the definition of "administrative action" to include "the decision by any state agency to enter into a contract to invest state public retirement system assets on behalf of a public retirement system."

[2] The Advisers Act cash solicitation rule requires: (1) that the solicitor not be subject to a statutory disqualification, such as an SEC order or certain criminal convictions; (2) that the cash fee is paid pursuant to a written agreement to which the adviser is a party; (3) that the adviser disclose to the client at the time of the solicitation or referral whether the solicitor is a partner, officer, director or employee of the investment adviser or of an affiliate of the investment adviser, and the nature of the affiliation; and (4) for third-party solicitors, that the third-party solicitor and adviser enter into a contract with specific provisions and the third-party solicitor provide the client with a written disclosure document describing: the names of the solicitor and investment adviser and the nature of the relationship, including any affiliation, between the solicitor and the investment adviser; a statement that the solicitor will be compensated for his solicitation services by the investment adviser; the terms of the compensation arrangement, including a description of the compensation paid or to be paid to the solicitor; and the amount, if any, for the cost of obtaining his account the client will be charged in addition to the advisory

requires, among other things, that a SEC-registered investment adviser disclose to the client the status of the solicitor as an employee, officer, director, or partner of the adviser or of an affiliate at the time of the solicitation or referral if the adviser pays a cash referral fee to that person to refer clients to the adviser employer.

The SEC stated in the release adopting the rule that fee arrangements may pose conflict of interest problems but they are not necessarily fraudulent and should not be prohibited.[3] With appropriate regulatory safeguards, the SEC noted, the payment of cash referral fees can be permitted consistent with the protection of investors, and "an outright ban of such fees would unnecessarily restrict the ability of investment advisers to make their services known to potential clients."[4] The SEC further noted that a client is aware when the recommended adviser is the solicitor's employer and will be aware of any inherent bias when an employee recommends the advisory services of his or her own employer.

In addition to a specific rule governing cash referral fees paid by SEC-registered investment adviser to solicitors, such advisers must establish, maintain and enforce a code of ethics under the Advisers Act prohibiting activities or transactions that violate the fiduciary obligations of the firm and its employees. All supervised persons of the adviser must report violations of the code of ethics to the adviser's chief compliance officer or other designated person, and the adviser must annually assess the adequacy and effectiveness of the code. Lastly, SEC-registered investment advisers have a duty to supervise their employees and are subject to a failure to supervise claim under the Advisers Act if the firm does not reasonably supervise employees or other persons under its supervision with a view to preventing violations of provisions of the Advisers Act. These provisions include supervision of sales and marketing employees to prevent violations such as a breach of fiduciary duty or violation of the cash solicitation rule.

Based on the foregoing, we therefore request that the definition of "placement agent" exclude employees, directors, and officers of SEC-registered investment advisers that have entered into an investment management agreement as a result of a competitive bidding process, such as an RFP or other state procurement process, with a California public retirement system to manage a portfolio of assets for an investment advisory fee, as well as employees of these advisers' affiliates that solicit for the adviser's advisory services. We

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fee, and the differential, if any, among clients with respect to the amount or level of advisory fees charged by the investment adviser if the differential is attributable to the existence of any arrangement pursuant to which the investment adviser has agreed to compensate the solicitor for soliciting clients for, or referring clients to, the investment adviser. The third-party solicitor also must provide the investment adviser's disclosure document (e.g., Form ADV Part II) to the client and obtain an acknowledgement of receipt of the required disclosure documents.

[3] *Requirements Governing Payments of Cash Referral Fees by Investment Advisers,* SEC Release No. IA-688 (July 12, 1979) at pg. 2.

[4] *Id.*

believe such an exemption is consistent with the purposes and policy of AB 1743 while retaining fair and consistent employment practices for SEC-registered investment advisers.

The IAA supports more transparency and disclosure in compensation structures for SEC-registered investment advisers managing a portfolio of assets for a California public retirement system. However, a prohibition on contingent compensation for employees of an investment adviser or its affiliate is not appropriately tailored to any potential abuse where the inherent bias of an in-house employee salesperson or employee of an affiliate is disclosed to the potential client in connection with the competitive RFP process.

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We greatly appreciate the opportunity to comment on aspects of AB 1743 as they affect SEC-registered investment advisers and their services to California public retirement systems. We would be pleased to work with you and the California public retirement systems to help develop further protections against pay to play abuses without unnecessarily restricting the lawful and fully-disclosed business practices of compensating sales and marketing employees of SEC-registered investment advisers on the basis of their legitimate efforts. Please do not hesitate to contact the undersigned at 202-293-4222 if we may provide you with any further information or if you have any questions regarding our comments.

Sincerely,

/s/ Monique S. Botkin

Monique S. Botkin
Senior Counsel

cc: The Honorable Ed Hernandez, O.D., Assembly Committee on Public Employees, Retirement and Social Security
The Honorable Alberto Torrico, Chair, Assembly Committee on Public Employees, Retirement and Social Security
California State Treasurer Bill Lockyer
California State Controller John Chiang
Robert Feckner, President, CalPERS
Marte Castanos, Esq., CalPERS
Ethan Jones, Chief Consultant, Assembly Committee on Elections and Redistricting
Karon Green, Chief Consultant, Assembly Committee on Public Employees, Retirement and Social Security